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BRACING FOR UNCERTAINTY

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Summary

¶1. For the second year in a row, the Government of Portugal has exceeded its own economic benchmarks, registering 1.9% GDP growth in 2007 vs. the projected 1.8 % and lowering the budget deficit below the eurozone 3.0% limit to 2.6%, a year ahead of schedule. These positive results validate the austerity measures PM Jose Socrates has taken since 2005 to restructure the Portuguese economy, including reducing the size of the government, revamping social security, and consolidating various budgets. Socrates has announced that he plans to loosen the economic belt in 2008, increasing some ministries' budgets, raising public investment, and lowering taxes. Despite cautious optimism for 2008, the government acknowledges that many challenges and risks remain. Unemployment stands at 8.0%, the highest in twenty years, as job creation has not kept pace with restructuring. The weak dollar and the sub-prime crisis will likely prove problematic as exports, one of the main engines behind Portugal's recovery, become more expensive and economic growth elsewhere in Europe slows down.

Overview and 2008 Economic Strategy

¶2. Since taking office in 2005, PM Socrates has focused his efforts on reversing the fortunes of the Portuguese economy. The Socialist Party leader took many difficult austerity measures to rein in the country's (then) exorbitant 6.1% budget deficit and implemented tough structural reforms to stimulate its stagnant economy which grew by only 0.3% that year. In 2006, the government focus on increasing revenue via taxes resulted in a decrease in the budget deficit to 3.9% vs. the projected 4.8%, and its efforts to overhaul public administration and to improve the trade and investment climate resulted in GDP growth of 1.4% vs. the projected 1.1%. In 2007, the government focus on reducing expenditures resulted in a decrease in the budget deficit to 2.6% vs. the projected 3.3%, and continued structural reforms resulted in GDP growth of 1.9% vs. the projected 1.8%. The government 's 2008 goals include reducing the budget deficit to 2.4% by increasing receipts by 0.3% and decreasing expenditures by 0.3%. (Note: The 2007 reduction of the budget deficit below 3.0% is a major accomplishment for the Socrates government. Not only did Portugal reduce the deficit below the 3.0% eurozone limit a year ahead of schedule as outlined in its 2005 Growth and Stability Pact, it registered the lowest

budget deficit since the creation of the modern Portuguese republic in 1974. End Note.)

¶3. With more money in government coffers, Socrates has announced that he plans to loosen the economic belt in 2008, increasing public investment by 6%, raising primary current expenditures by one-quarter percent, and transferring on average 4.7% more money to local municipalities. (Note: Transfers were frozen for the last two years. End Note.) Some economists are calling for an even greater increase in public investment and for an overall reduction in taxes, and with the government announcing its intention to decrease selective taxes, it is no longer an issue of if, but when.

	Percent Change				
	2005	2006	2007	2008*	2009*
Deficit	6.1	3.9	2.6	2.4	1.8
GDP	0.3	1.4	1.9	2.2	2.8
Inflation		3.0	2.4	2.4	2.0

*Projected
Source: Government of Portugal

Challenges for 2008

¶4. Despite Socrates's cautious optimism that moderate growth will continue in 2008, many challenges and risks remain. If the reforms are to be sustainable, it is important that the government not ease unpopular measures, such as decreased social benefits or increased welfare contributions, in anticipation of 2009 legislative elections. It is also important for the government to correct lingering imbalances with a special focus on ongoing fiscal consolidation and improvement of external financing requirements; and while the deficit is down and growth is up, reform of public administration is behind schedule.

¶5. The sub-prime crisis and weakening dollar have affected European growth in general and Portuguese exports and investment in particular. Unemployment also presents a continuing concern for the Portuguese government, as job creation has lagged. While acknowledging these worrisome issues, Finance Minister Teixeira dos Santos has noted that Portugal is better prepared today to face these uncertainties than it was a few years ago. Such assurances have done little to allay the public's pessimism, however. Economist Antonio Mendonca, for instance, noted that, while Portugal is better prepared, it is "still not well prepared." On the positive side, the IMF reported in its October 11, 2007 report that the banking sector is sound and well-supervised. (Note: Portugal has a tradition of seeing the glass half empty rather than half full on many issues. Despite improving economic indicators, a Eurostat survey found that 88% percent of Portuguese thought the economic situation was bad and 91% thought the employment situation was bad.)

Export and Investment Growth

¶6. Exports and investment are the two external factors that have had the greatest impact on the Portuguese economy in recent years. Export growth has been the principal motor of the economic recovery as companies have restructured, becoming more productive and competitive. Furthermore, businesses have begun to refocus their efforts on higher value products. Fuel exports, in particular, have proven very lucrative as Portugal has begun to tap the excess capacity of its Sines refinery. However, the dollar's devaluation will continue to hurt Portugal's export growth. As the European economy begins to slow down, the demand for Portuguese exports will likely fall, as over 70% of Portuguese exports are EU-bound. Domestic demand, buoyed by investment and consumption, will somewhat counterbalance the

decrease in export demand.

¶7. On the other side of the equation, the government already has in the pipeline close to 1.5 billion euros in foreign and national private investment. These investments, mostly in automobiles and automobile parts, when finalized, will account for nearly half of the government's 2008 private investment goal. In addition, increased investment is being reflected in the greater sales of cement and heavy vehicles. Furthermore, most economists expect the government to increase public investment by 6% in 2008 as part of its belt loosening campaign and by even more in 2009 in the run-up to that year's national elections. Major projects in the works include a new airport and high-speed rail system.

	Percent Change			
	2006	2007	2008*	2009*
Gross Capital Fixed Formation		2.6	3.3	3.1
Exports	9.1	7.0	4.9	6.0
Imports	4.3	4.1	2.9	3.7

*Projected
Source: Bank of Portugal

Unemployment

¶8. Unemployment will be the government's biggest challenge in 2008 and will likely become an election issue should conditions not improve prior to the 2009 elections. At 8.0% in 2007, the rate of unemployment is the highest it has been in 20 years. Exacerbating the situation, the government has fallen behind its job creation goal. Although the government expects job creation to accelerate in 2008, it does not expect unemployment to decrease until 2009 as more individuals lose their jobs due to economic restructuring.

¶9. The government's effort to reduce the size of the civil service by 75,000 positions by 2009 from an all time high of 748,000 in 2005 further complicates the employment situation, as it has only succeeded in eliminating close to 40,000 jobs to date. The government has established vocational centers to retrain employees who have lost their jobs as a result of economic reforms. Many newly created jobs are in the mid- and high-tech fields and provide greater financial compensation than the national average. The average eurozone unemployment rate was 7.1%.

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	2005	2006	2007	2008*	2009*	2010*
Unemployment	7.5	7.6	8.0	8.0	7.6	6.9

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*Projected
Source: Portuguese National Statistics Institute

2008 Ministry Budget Highlights

¶10. In 2007, the government cut most ministries' budgets to help reach its budget deficit reduction goal of 3%. Having successfully done so a year ahead of schedule, the government has increased the budget of several ministries central to its national growth policy, including the Ministry of Economy, which holds the energy portfolio, and the Ministry of Environment. The Ministry of Economy's budget saw a 23.5% increase to be dedicated mostly to supporting small and medium-sized enterprises and the promotion of renewable energy. The Ministry of Environment gained from a 13.7%

decrease in its Carbon Fund contribution, 127 million euros in 2008 vs. 146.1 million in 2007. The increase in the Ministry of Science and Technology and Higher Education's budget is designed to create a solid science and technological base and generate employment in that field, promote research and development and register new patents, and boost the number of doctorates granted. The huge decrease in the Ministry of Public Works budget is due to the newly designated status of "state-owned enterprise" given to its roadway division. All costs and revenue generated from roadworks will not be included in the budget. With regard to Foreign Affairs, the government decreased that ministry's budget by 7.1% following completion of its EU Presidency on December 31, 2007. The Ministry of Defense budget, which includes a 8.5% increase, focuses on restructuring and modernizing the armed forces, with particular attention paid to technical military cooperation and the implementation of a national oceans strategy. The 8.5% increase is due, in part, to the new requirement that expenditures be allocated to the year in which the equipment is acquired, not the year(s) in which payments are made.

Ministry	Percent Change Over 2007 Budget
Internal Administration	-0.7
Agriculture	4.9
Justice	7.9
Environment	12.7
Foreign Affairs	-7.1
Finance	4.9
Economy	23.5
Public Works	-53.6
Social Security	3.9
Health	0.9
Education	0.0
S&T and Higher Education	8.9
Culture	14.9
National Defense	8.5

Comment

¶11. Prime Minister Jose Socrates, Finance Minister Fernando Teixeira dos Santos, and Bank of Portugal Governor Vitor Constancio all predict continued moderate economic recovery for 2008 and 2009 but acknowledge higher than usual uncertainty. The European Commission, OECD and IMF believe the government's forecasts are too optimistic, and while Constancio may agree in some cases, he is quick to point out that the government has yet to revise predictions made before the acceleration of the global financial crisis. Nevertheless, the government achievements paint a mixed picture, with the country's 2007 GDP growth of 1.9% registering the highest in the last six years but coming in as one of the Eurozone's lowest. Much work remains to be done before Portugal's economy converges with the European average. Despite outward confidence and optimism, the government is concerned that Portugal's per capita GDP stands at 65.6% of the European average, having dropped to 19th place within the EU-27, behind Estonia, in 2008. This sobering reality check will likely keep the government's efforts focused on the economy as the country heads for legislative elections in 2009. The economy, after all, will make or break the Socialist Party's chances at reelection.

Stephenson